**SUNK COSTS**

A cost that has already been incurred and thus cannot be recovered. A sunk cost differs from other, future costs that a business may face, such as inventory costs or R&D expenses, because it has already happened. Sunk costs are independent of any event that may occur in the future.

When making business or investment decisions, individuals and organizations typically look at the future costs that they may incur, by following a certain strategy. A company that has spent $5 million building a factory that is not yet complete, has to consider the $5 million sunk, since it cannot get the money back. It must decide whether continuing construction to complete the project will help the company regain the sunk cost, or whether it should walk away from the incomplete project.

There's an old saying that you shouldn't throw good money after bad. It's founded in the common-sense principle that just because you've spent money on something up to a point, there's no reason to keep spending money on it if the chances of recovering your investment are doubtful. Economists have a term for spending on things you can't recoup your money from; they're called "[sunk costs](http://www.investopedia.com/terms/s/sunkcost.asp)."

Businesses with the highest sunk costs tend be those with the greatest barriers to entry and biggest startup costs. These would include capital-intensive industries that require large buildings, expensive tooling and a high ratio of fixed to variable costs. In fact, the level of sunk cost is a major barrier to entry to many of these businesses.

The concept is simple and straightforward, but sunk cost plays a major role in many personal and business decisions. It's important to have a decision-making strategy when confronted with the need to spend more money when the recoupment of the sunk cost may be in jeopardy.

**Sunk Cost Dilemma**

The best way to illustrate this concept is with an example that has played out many times over the past several years. You're a homebuilder [during the bubble](http://www.investopedia.com/terms/h/housing_bubble.asp) and you've started work on 20 spec homes in a small development. You've cleared the land, prepped the home sites and brought in power, water and sewer. Halfway through construction of the homes, the real estate market starts to crash. Do you keep working and finish the construction, hoping that the market will soon improve? Or, do you stop work and save the money you would have spent finishing all the homes?

At the point in time where you make this decision, everything you've spent so far is sunk cost. In this case it's a considerable amount of money, and it may be painfully difficult to walk away. If you do, that money is lost forever. If you don't, you run the risk of spending even more money that you'll never recover if economic conditions don't improve fast enough. The dilemma can be framed as one of certain loss versus uncertain success.

During the U.S. recession many homebuilders chose to keep working, assuming this economic recovery would mirror past experience. It didn't and many of them failed because there has been no sustainable rebound in the real estate market. In retrospect, they would have been better off ignoring their sunk costs and cutting their losses. The sunk cost dilemma is not resolved as long as the project is neither completed nor stopped.

**Financial Aspects**

To some degree, all businesses incur sunk costs at various times. When making a decision, it's useful to compare the benefits that will accrue from each choice to the additional costs associated with each. Economists refer to this approach as "acting on the margins" because you're focusing on the relative merits of future actions. This type of thinking should lead to the choice that provides the greatest net additional benefits, regardless of what has happened in the past. Since sunk costs will not change as a result of any choice you could make, they should be irrelevant for your next decision.

In a financial sense, a line can be drawn between sunk costs and other costs you incur that have no immediate benefit. An example would be insurance premiums that can be paid for years and years without ever making a claim. While those premiums might be considered sunk in a personal sense, they're not, because they provided you with a continuing benefit by protecting you from potential losses. The fact that you were lucky enough not to need the insurance doesn't mean the money was wasted.

**The Bottom Line**

If you bought an advance ticket to a movie and then heard from several moviegoers that it was terrible, would you still go see it if you couldn't get a refund or resell the ticket? Made on a purely economic basis, you wouldn't go because the ticket is a sunk cost. On a psychological level though, you might believe if you don't go you won't get your money's worth. Plus, there's always the chance that you might like it. But if you go and don't like it, you've not only wasted the cost of the ticket but a few hours of your time. You've compounded the financial loss with an opportunity loss.

In a strict economic sense, a rational person ignores sunk costs and only considers [variable costs](http://www.investopedia.com/terms/v/variablecost.asp) when making a decision. To do otherwise would prevent one from making a decision purely on its merits. However, this approach is in conflict with the irrational human tendency to avert loss under any circumstances. Sometimes it's not worth crying over spilled milk.

Video: <https://youtu.be/PEg4yCNeE4g>